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Nuclear Decommissioning Funds

AMERGEN ENERGY CO., LLC v. U.S., 106 A.F.T.R. 2d 2010-6158 (Fed. Cl. 2010)

The purchase and sale of a nuclear plant presents complicated tax issues arising out of the fact that the plant owner is obligated to decommission the plant and provide site cleanup in the future. The seller usually transfers to the buyer both a qualified and a nonqualified decommissioning fund. The qualified fund is one into which tax deductible contributions can be made. The nonqualified fund is more like a sinking fund. Although certain means have been developed to work around the worst of the tax problems, the prototypical case looked like this:

Example 1: Buyer pays $100 cash for nuclear plant worth $100 (seller's basis is $50) subject to an environmental clean-up liability of $500 (present value based on section 483 principles), plus a fund that seller has built up containing $500 cash to be used for the cleanup. Buyer assumes contractual liability for the liability and agrees to hold seller harmless. Seller recognizes $50 gain ($100 + $500 - $50 - $500), and can claim an ordinary deduction of $500. Reg. § 1.461-4(d)(5). Buyer must recognize income of $400 at the time of the closing of its purchase ($500 - $100). Reg. § 1.338-6(b)(1). Buyer takes a $500 basis in the cash and a zero basis in the plant and can deduct amounts paid to decommission in the future. Buyer and seller report on the accrual method.

The Root of the Problem

When a corporation makes a qualified stock purchase of the stock of another corporation, it can agree with the seller in some cases to make a Section 338(h)(10) election. As a result, the acquired corporation is treated as selling all of its assets to a new corporation for the price the acquirer paid for the stock plus the acquired corporation's liabilities. That election converts the stock sale into a deemed asset sale that requires allocation of the deemed purchase price among the corporation's assets. That need to allocate purchase price confronts the acquirer with the same issue confronted by any purchaser of the assets of a business under section 1060, which also requires purchase price allocation among the assets, relying on the regulations under Section 338: what is the purchase price?

Those regulations do not tell the acquirer what is the purchase price paid, but rather they defer to general principles of law. When the purchase price includes an agreement to do or pay something in the future, that part of the cost may not be includable in basis until economic performance occurs under Section 461(h). This limitation can be a surprise to some tax professionals: to learn that Section 461(h) applies not only to deductions (which is its heading), but also to basis.

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

Accounting Method

The link between Section 461(h) and basis of purchased property is Reg. Section 1.446-1(c)(1)(ii). It is the general accounting method regulation. As to accrual method taxpayers, it requires that for all federal income tax purposes, an item of expenditure can be taken into account only when both the all event test has been satisfied and economic performance has occurred under Section 461(h).

Section 461 is titled: "General Rule for Taxable Year of Deduction." You would not think it establishes rules for original cost basis. However, this regulation dating to 1992 converts the economic performance rule for deductions into a limit on original cost basis.

This limit becomes important when an accrual method buyer of property assumes a contingent liability in the purchase. Historically, it was thought that such a liability assumption entered into basis unless it was too contingent to be added to basis under general principles. *See*, for example, *Albany Car Wheel*, 40 T.C. 831 (1963). However, the economic performance test can produce very different results.

Obviously, buyer and seller are treated very differently in the example above. Buyer will be very unhappy, both due to recognizing income upon buying a plant and due to getting no basis in the plant. There are other ways the transaction can be structured to avoid these results. However, if structured as in the example, the seller is under the usual duty to recognize income at the earliest possible moment and to value the liability assumption for income purposes. However, the IRS believes the buyer is assuming a liability to perform services in the future and does not have economic performance until it performs the services, and thus does not acquire basis for the $500 until that time. Reg. section 1.461-4(d)(4). See LTR 200243024.

The Litigation Problem

One nuclear plant buyer wanted to possibly derive some admissible evidence from the fact that its seller got a ruling from the IRS that the seller, as in the example above, would realize as income the amount of the nonqualified decommissioning fund liability and also could deduct it as an ordinary deduction, even though it had not paid it. Neither had the buyer paid it, but the IRS denied the buyer any basis for the assumption, as in the example.

The IRS refused to even admit that a certain numbered LTR was the taxpayer's seller's LTR. The taxpayer moved to enforce the discovery request. In *AMERGEN ENERGY CO., LLC v. U.S.*, 106 A.F.T.R. 2d 2010-6158 (Fed. Cl. 2010), the court refused to force the IRS to reveal anything about the seller's ruling.

This was not a case where the taxpayer was arguing that it should be treated like other similarly situated taxpayers who got more favorable treatment in rulings than it got. Rather, it is about a taxpayer wanting to prove that it satisfied the all events test for assuming a liability as to which the IRS ruled that the all events test was satisfied on the seller's side. This ruling does not bode well for discovery about rulings from the IRS in the Claims Court.

For additional information, call Jack Cummings at 919.862.2302.

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Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.239.3319

Robert T. Cole
202.239.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.239.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.239.3394

Clay A. Littlefield
704.444.1440

Ashley B. Menser
919.862.2209

Tola Ozim
212.210.9533

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Matthew A. Stevens
202.239.3553

Gerald V. Thomas II
404.881.4716

Charles W. Wheeler
202.239.3308